United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

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United States Court of Appeals

FOR THE SECOND CIRCUIT

TELEDYNE INDUSTRIES, INC.,

Plaintiff-Appellee,

against

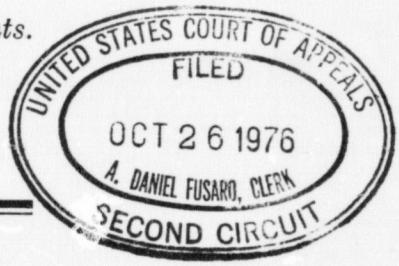
ODIF PODELL, SIMON SRYBNIK, NICHOLAS ANTON, SAUL WALLER,

Defendants-Appellants,

and

EON CORPORATION and KERNS MANUFACTURING CORP.,

Defendants.



ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

APPELLANTS' BRIEF

(Judgment After Trial)

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APPELLANTS' BRIEF

PRELIMINARY STATEMENT

This is an appeal by the defendants-appellants from a judgment of the United States District Court, Southern District of New York (Knapp, J.) which held defendants-appellants individually liable for conversion.

ISSUES PRESENTED

1) Did the District Court properly find that appellee had a special interest or property right in an alleged trust res such that a cause of action in conversion could be sustained?

2) Assuming that appellee had a sufficient enough interest in the trust res to sustain the cause of action in conversion, did the District Court properly hold the individual defendants-appellants liable for conversion?

FACTS

Eon Corporation [hereinafter "Eon"], founded in 1961, was engaged in the research, development, and marketing of medical, nuclear, electronic and optical devices. (A-26)* In or about 1968, the company acquired the American Marc Division located in Inglewood, California, which division was engaged in the manufacture of diesel engines and electric generators. (A-27) The head of the American Marc Division was M. James Leonard [hereinafter "Leonard"], who was also a vice

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*numbers in parenthesis refer to pages in the Joint Appendix.

president and director of Eon. All of the appellants were, at the time of the events in question herein, directors of Eon. Nicholas Anton was the President of Eon; Odif Podell, Chairman of the Board; Saul Waller was Secretary of the corporation and Simon Srybnik was a shareholder. (A-27)

On June 20, 1969, Eon, through its American Marc Division, was awarded a contract by the United States Army, No. DAA K01-69-C-A359 (Pl. Trial Ex. 10) for the manufacture, production and delivery of 1.5 KW generator sets. In March of 1971, appellee, along with other companies, had unsuccessfully bid directly to the government for the manufacture and sale of 2300 of the same 1.5 KW generators then being manufactured by American Marc. (A-27)

Shortly after Eon had been awarded the government contract, its Board of Directors decided to terminate certain manufacturing operations at American Marc. In conformity with the decision, Eon's Board of Directors directed Leonard to seek out possible subcontractors from those manufacturers who had sought to sell directly to the United States Army. Eon's interest in locating a subcontractor was communicated by Leonard to one Eugene Walper [hereinafter "Walper"] who in turn

contacted Harold Rouse [hereinafter "Rouse"], a Teledyne vice-president. (A-27) Since Teledyne had submitted an unsuccessful bid to the government to manufacture the same type of generator, Rouse expressed an interest in subcontracting from Eon.

Thereafter, two representatives of Teledyne (Rouse and Coleman) met with Leonard in Los Angeles on May 10, 11 and 12, 1971 to conclude a deal. Two contracts were signed on May 12th; the first Purchase Order No. M-1257, a subcontract arrangement whereby Teledyne agreed to manufacture 4,372 generator sets at a unit price of $360 and to deliver them according to the provisions of the original army contract; the second, an Inventory Agreement which provided, in part, that Teledyne would purchase from Eon all of the generator set parts and material in Eon's possession as of August 31, 1971. (A-28)

The purchase order, which had been thoroughly reviewed by Teledyne's representatives with its corporate counsel (A-248-254) and again reviewed by Teledyne's personnel in July 1971 through October 1971 contained the following terms and conditions:

1. The parties were designated to be in a vendor-vendee relationship;

2. The payment "Terms" agreed to were "net 30-days";

3. The specific provisions of the underlying army contract were incorporated by reference in the sale from Teledyne to Eon;

4. Teledyne annexed its carefully drafted attachment entitled "Vendor Terms and Conditions," which did not contain any reference to the creation of a secured position arising out of a trust relationship;

5. Finder's fees and brokers commissions were outlawed;

6. The purchase order could not be orally modified or changed. (A-1091-1100)

In addition to the specific written agreements, the parties also entered into an oral agreement concerning the method by which Teledyne would be paid by Eon. Two letters, introduced into evidence, set forth the basic outline of the agreement. In a letter from Rouse to Leonard dated May 13th, Rouse indicated that:

> "Eon will arrange with the Bank of America to hold the funds received from 1.5 KW generator sales covered on Eon Purchase Order #M-1257 in a special account, which will be used to pay TCM invoices." (A-1108)

The arrangements were further detailed in a letter dated May 25, 1971 from Leonard to the Palos Verde's branch of the Bank of America. The bank account utilized by Leonard for this purpose was a preexisting one and the letter of instructions indicated that monies received from the government by American Marc would be deposited in the account and thereafter the bank would be directed to utilize such funds to pay certain of the Teledyne invoices. The remaining portion of monies in the account were to be "disbursed according to the direction of American Marc Division of Eon Corporation." (A-1113)

After Teledyne commenced production and delivery, Eon was unable to pay outstanding invoices. In order to pay corporate obligors other than Teledyne, monies which Eon had received from the government in payment for sold generator sets, deposited in the Bank of America account, were withdrawn and utilized for that purpose.

On the basis of the foregoing, the District Court found that the special account set up in the Bank of America created a "special interest" in favor of Teledyne and that when the individual defendant-appellants, acting within their corporate capacity and without knowledge of the existence of any restrictions with respect to said account, authorized payment from the account of other corporation obligations, they had converted monies of Teledyne.

SUMMARY OF ARGUMENT

Defendants-appellants contend that, as a matter of law, the transactions involving the method of payment by Eon to Teledyne did not create a "special interest" in the Bank of America account on behalf of Teledyne such as would support a cause of action in conversion. The uncontroverted evidence indicates that the parties dealt at arms length and established a typical vendor-vendee relationship.

It is urged that a security arrangement, such as found by the court below, between businessmen, acting at arm's length, would not have been left to Leonard to confirm in writing in the manner as testified to by appellee's witnesses. (A-147) The District Court judgment is a personification of form over substance, particularly in view of the fact that Eon Corporation retained absolute, exclusive control over the monies deposited in its bank account and also retained the right to withdraw monies from the account to pay Teledyne and to pay others. In rendering its decision, the District Court ignored the testimony of Teledyne's own witness, Leonard, who set forth his understanding of the banking arrangements as follows:

> "Q. With respect to this Bank of America account, I don't want to put words in your mouth, but do I understand correctly that the idea of the Bank of America account was to assure Teledyne that it would be paid under the subcontract?

A. Well, it was their request that we have an account where the monies would be deposited and that we would direct that the monies be paid out of that account.

* * *

Q. Was it also their request that the monies not be paid out to anyone else until Teledyne invoices had been satisfied?

A. No.

Q. What was the protection that Teledyne was going to receive from this bank account if other creditors could be paid out of the same account?

* * *

A. I don't know.

* * *

A. My understanding of the bank account and the reason it was set up, and the way it performed, was exactly as described in the documents that you have and Eon has, that the checks when they came in were to be deposited. Those were then to be identified with invoices that were outstanding from Teledyne and the payments would be made in accordance with those amounts that were due to Teledyne out of the account. And that is the way that it operated.

Q. Did you instruct Bank of America, or to your knowledge did anyone else from Eon instruct the Bank of America not to pay out any sums from the account until the Teledyne invoices had been paid?

A. No, that wasn't ever set up that way and it wasn't requested that way." (A-734-36)

Defendants-appellants also urge that even if the evidence was sufficient to support the finding of a "special interest" on behalf of Teleyne in the Bank of America account, the individual defendants-appellants cannot be held responsible for conversion by reason of the fact that a fiduciary relationship did not exist, that there is no California case with facts similar to the facts involved herein in which conversion was found against individual directors of a corporation and further that the individual directors of Eon Corporation are insulated from liability by reason of their corporate-director status.

ARGUMENT

POINT I

TELEDYNE DID NOT HAVE A TRUST INTEREST IN THE BANK OF AMERICA ACCOUNT SUFFICIENT TO SUSTAIN A CAUSE OF ACTION IN CONVERSION.

The District Court held, without judicial authority, that the documentary evidence supported its finding that Teledyne had a "special interest" in the Bank of America account. The District Court also

concluded, again without judicial authority, and contrary to the terms of the purchase order, that a fiduciary relationship existed between Eon and Teledyne with respect to the monies received by Eon from the government and deposited in the Bank of America account. It is respectfully submitted that the court erred in finding a "special interest" and fiduciary relationship, and that the legal authorities cited by the court are not controlling.

In order for the court below to have found a "special interest" in the bank account sufficient to sustain the conversion action, it was necessary for the court to have concluded that the agreements relating to the bank account established a "trust" or "quasi trust" relationship between the parties. It is submitted that where, as here, the parties entered into a classic vendor-vendee relationship and where, as here, no mention of a security arrangement was contained in the written documents signed on May 12th, there was no justification for Teledyne to place any trust or confidence in Eon so as to impose the duties of a fiduciary thereon. Rader v. Boyd, 252 F.2d 585 (10th Cir. 1958); Vargas v. Esquire, Inc., 166 F.2d 651 (7th Cir. 1948); Twomey v. Mitchum, Jones & Templeton, Inc., 262 Cal

App. 2d 690 (Dist. Ct. App. 1968); Estate of Cover, 188 Cal. 133, 204 P. 583 (1922).

In Vargas, supra, the Court of Appeals reversed a judgment for the plaintiff and remanded to the lower court, with instructions to dismiss plaintiff's complaint on the grounds that a fiduciary relationship asserted by the plaintiff did not exist as a matter of law. The court concluded that a fiduciary relationship arises:

> "[W]henever the circumstances makes it certain that confidence was reposed on one side and domination and influence resulted on the other. But where a fiduciary relationship does not exist as a matter of law, the burden of proving facts from which such a relationship arises is upon the person seeking to establish the relationship, and the proof must be clear, convincing, and so strong as to lead to but one possible conclusion. [citations omitted]" 166 F.2d at 653

Likewise, in Rader, supra, the court affirmed the denial of a claimed breach of a fiduciary relationship between a creditor and a bankrupt debtor. It held:

> "But, we think the proof falls short of establishing a fiducial or confidential relationship which would equitably forbid Boyd to assert his claims. While fiducial or confidential relationships recognized and enforced in equity do not rest upon any particular legal

> relationship, they do necessarily spring from an attitude of trust and confidence and are based on some form of agreement, either expressed or implie., from which it can be said that the minds have met to create a mutual obligation. A confidential relationship is never presumed and the burden is upon the party asserting it. [citations omitted] Parties may assuredly deal at arm's length for their benefit without raising a confidential relationship between them. The parties here did enter into negotiations looking toward some arrangement, but the evidence is not clear what relationship was contemplated. It cannot be said that they entered into a partnership, or a joint venture, or that Boyd became Rader's agent for the purpose of refinancing his properties. Indeed, the proof does not show that Boyd acquired any confidential facts or information in his relations with Rader which were not a matter of record or immediately available to any interested party. It may be that his conduct did not conform to the highest ethical standards, but having no fiducial relationship, his duty arose no higher than the morals of the market place." 252 F.2d at 587.

In Twomey, supra, a stockholder-churning case, the California court concluded that a fiduciary relationship existed between a stockbroker and its client. The court stated that:

> "Confidential and fiduciary relations are, in law, synonymous and may be said to exist whenever trust and confidence is reposed by one person in the integrity and fidelity of another. The very existence of such a relation precludes the party in whom the trust and confidence is reposed from participating in profit or advantage resulting from the dealings of the parties to the relation." [citations omitted] 262 Cal. App.2d at 692.

Where, as here, Eon and Teledyne engaged in a course of arm's-length dealings, and Eon retained all rights of control to its bank account and to the use of the funds coming into it, resulting in an intermingling of funds, with an understanding that there was an obligation to pay a debt to Teledyne therefrom, and there existed no trust agreement or trust indenture, or express security agreement with any designation of Eon as agent or trustee, the disappointed expectations of Teledyne do not give rise to the creation of a fiduciary relationship or of Eon's intention to assume the obligations of a trustee. 48 Cal. Jur. 2d, Trusts §16; Elliott v. Bumb, 356 F.2d 749 (9th Cir. 1966), cert. den'd, 385 U.S. 829, 17 L.Ed.2d 66; Johnson v. Morris, 175 F.2d 65 (10th Cir. 1949); Donald W. Bauer v. Frank, 219 F.2d 509 (D.C. Cir. 1955); Matter of Tele-Tone Radio Corp., 133 F.Supp. 739 (D.N.J. 1955);

Gonsalves, Jr. v. Hodgson, 38 Cal. 2d 91, 237 P.2d 656 (1951); Downey v. Humphreys, 102 Cal. App.2d 323, 227 P.2d 484.

In Gonsalves, supra, the California court observed that a fiduciary relationship between the parties did not exist and stated:

> "The parties here were engaged in a course of arm's-length dealing. Hodgson was to use his knowledge and skill in the supervision of the construction. Gonsalves and his associates were given and exercised a supervisory check on all phases of construction. They retained rights of control which completely negative any implication of a fiduciary relationship. There being no trust or fiduciary relationship, the only breach which could have occurred would have been one of a strictly contractual obligation." 38 Cal.2d at 99.

In Matter of Tele-Tone, supra, the court rejected a claim that the deposit of monies in a so-called "tax account" created a trust. The court observed that a trust could not exist because the depositor of the funds had the right to withdraw monies from the account. Likewise, in Van Denbergh v. Walker, 47 F. Supp. 549 (E.D. Pa. 1942), the court held that where a depositor of funds did not surrender or divest itself completely of all interest

in or control over funds, the funds remained an asset of the depositor, subject to being applied to the payment of its obligations.

Van Denbergh, supra, involved a paternal association, the finance committee of which had withdrawn a sum of money from its general funds and put it in a checking account in the name of the association's secretary. The purpose of the deposit was to segregate a general emergency fund to pay legal fees or other emergency expenses as they might arise. The court rejected the argument of the association's attorneys who sought to collect their fees from the checking account on a trust fund theory, holding that:

> "[T]he [association] did not at any time surrender control of the disposition of the funds. . . . [T]he fund . . . . could have been applied to any purpose of the [association] . . . . There is certainly nothing in the record to suggest that [the association's secretary] was given anything like the specific instructions as to the disposition of the fund which would be necessary to create a trust. . . . He would have applied it as directed at any time by the Finance Committee." 47 F. Supp. at 551.

It is respectfully submitted that the facts in the instant case are similar to those in Van Denbergh and Tele-Tone. It is clear that Eon retained control over the disbursement of the money in the account.

In the absence of the abandonment of control, a trust fund was never established.

Reasonable business practices, of which the court below could have taken judicial notice, also strongly mitigate against a finding of a trust or fiduciary relationship.* Despite extensive documentation and written agreements, there is not a single mention of a trust or security arrangement in the purchase order executed by the parties. This is so even though Teledyne had the purchase order and agreement examined by their corporate counsel in California. (A-248) From a business and legal view, it is incredible that a provision relating to security, allegedly so important to Teledyne, would not have been included in the writings executed by the parties on May 12th.

Moreover, the documentary evidence relied upon by the District Court clearly reflects that the parties did not intend to establish a trust or special interest

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*Judge Knapp specifically noted the sloppiness of the transaction, yet dignified the sloppiness to the status of a special interest relationship. (A-343,579)

arrangement but, rather, a vehicle for the payment of invoices within the context of their vendor-vendee relationship. Thus, Leonard's letter of instructions to the Bank of America does not indicate that the bank was to pay Teledyne invoices upon its receipt thereof, but rather that "the bank will be directed [by Eon] to use the funds to pay the amounts of the invoices which were included in the payment check, directly to TCM by cashier's check. The balance in the account will be disbursed according to the direction of American Marc Division of EON Corporation." It is respectfully submitted that in reserving to Eon control over the bank account, the disbursement of the funds and, ultimately, whether or not the invoices would be paid, the parties clearly negated any intent to establish a trust relationship.* If the invoices were not paid out of the funds deposited in the Bank of America, appellee might possibly have a cause of action for breach of contract against Eon, but certainly,

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* Under appellee's theory of trust or special interest, the mere receipt of payment from the government by Eon would constitute a waiver of any claim for breach of the purchase order by Teledyne. There is no evidence that the parties intended such a drastic consequence.

under the facts, there can be no cause of action in conversion or interference with a property right.

The District Court placed significant emphasis in reaching its conclusions concerning the trust relationship upon a letter written by Leonard to Teledyne dated October 11, 1971 in which Leonard referred to the special bank account in the following words:

> ". . . you have the largest bank in California acting as a monitor in your behalf. . ." (A-1115)

Focusing on the word "monitor," the District Court stated that "one may query . . . what conceivable monitoring could be performed if the account were administered in the manner in which defendants contend." (A-47-48)

Monitoring, however, is merely a form of observation; one can monitor something, i.e., observe it and even report on the observation without exercising any control whatsoever on what is being observed. It is therefore quite possible that Leonard, by the use of the word 'monitor,' meant simply that the bank would observe when the progress payments were deposited in the special account and to whose order checks were

written on this money, and report its observations to Teledyne. Such an interpretation not only is wholly consistent with appellants' position, but also with the testimony of appellee's own witness, Leonard, who specifically contradicted the fact that there was any type of a special arrangement which would, in law, support the establishment of a fiduciary relationship.*

By reason of the foregoing, it is urged that the District Court erred in finding a fiduciary and trust relationship sufficient to sustain a cause of action in conversion. Where, as here, there is no security agreement, no present assignment of funds to Teledyne, no present assignment of accounts receivable or present assignment of a designated payment to become due to a corporation, it is respectfully submitted that, at best, the evidence established a potential breach of contract action but did not support a finding of conversion.

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* Judge Knapp also referred to the fact that he found the testimony of Coleman and Rouse to be credible. The Court is referred to appellants' companion appeal from the denial of their motion for a new trial on the basis of newly discovered evidence in which the credibility of Coleman and Rouse is severly tested.

The burden of proof in establishing a trust or that a special interest was intended to be created is one which can only be satisfied by establishing circumstances which would show "beyond a reasonable doubt" that a trust was intended to be created. In Re Assoc. Gas and Elec. Corp., 137 F.2d 603 (2d Cir. 1943); Beaver v. Beaver, 117 N.Y. 422; Sparks v. Lauritzen, 56 Cal. Rptr. 370 (Dist. Ct. App. 1967). Where, as here, the proof adduced at the time for trial failed to establish beyond a reasonable doubt that a trust and fiduciary relationship was intended, the judgment in conversion must be reversed.

POINT II

TELEDYNE DID NOT HAVE A "SPECIAL INTEREST" IN THE BANK OF AMERICA ACCOUNT

Although the District Court found that the individual defendants-appellants had converted the "trust" fund by approving the payment of other corporate obligations, it is respectfully submitted that the controlling law of the State of California mandates a reversal.

Although there are numerous cases holding that a person, whose interest in a chattel is less than full ownership, may maintain a conversion action, none of the cases support such a finding on grounds as tenuous as

the instant case. For example, it has been held that a conversion action may be maintained by a chattel mortgagor, Camp v. Ortega, 209 Cal. App. 2d 275, 25 Cal. Rptr. 873 (Dist. Ct. App. 1962); by a conditional vendee, Carvel v. Weaver, 54 Cal. App. 734, 202 P.897 (Dist. Ct. App. 1921); by a conditional vendor, Covington v. Grant, 82 Cal. App. 749, 256 P.213 (Dist. Ct. App. 1927); and by an attaching creditor against a sheriff holding property in custody as the creditor's agent, McCaffey Canning Co., Inc. v. Bank of America, 109 Cal. App. 415, 294 P.45 (Dist. Ct. 1930).

In each of the above cases, the plaintiff had at one time exercised direct control over the chattel through ownership, possession or through initiating legal procedures which transferred possession from the owner to the sheriff. In the instant case, however, appellee never exercised any direct control over the progress payments received by Eon from the government.

The District Court found that an action for conversion could be maintained by a person, who, although not in possession, had a "special interest" in the property giving him a right to possession at the time of the conversion. Since it is obvious that a trust

fund fiduciary relationship was not established in law, in the absence of a special interest, a cause of action for conversion cannot be maintained. The cases cited by the District Court cannot support a finding of a special interest.

In Pope v. National Aero Finance Co., 236 Cal. App.2d 722, 46 Cal. Rptr. 233 (Dist. Ct. App. 1965), the court held that a special interest in law had not been established. In that case, the plaintiff was a member of the flying club and had a right to fly a certain aircraft. Documentation had been signed with respect to this right. Plaintiff was unaware that encumbrances had been placed upon the aircraft. When the mortgagee foreclosed upon the aircraft and took possession, plaintiff lost his right to fly the plane. Since plaintiff contended that he was a one-fourth owner of the plane, he brought a conversion action against the refinancing mortgagee. The court held that a conversion action could not be maintained because the plaintiff did not have a possessory interest in the chattel. The court concluded that since the plaintiff had never become an owner of the plane or of any special interest

therein, he had no rights as against the mortgagee.*

In Carvel v. Weaver, 54 Cal. App. 734, 202 P. 97 (Dist. Ct. App. 1921), plaintiff brought an action for damages and conversion of an automobile. The facts indicated that plaintiff had purchased the car in question from the assignors of defendant under a conditional sales contract. When the plaintiff failed to make a timely payment, defendant commenced an action and obtained possession of the automobile. Thereafter, that judgment was reversed on appeal and an order entered directing the defendant to return the automobile to the plaintiff upon the payment of the balance due under the contract. Defendant refused to return the car contending that he did not have possession of the vehicle. Upon those facts, and in reliance upon rights arising under the conditional sales contract, the court upheld plaintiff's action in conversion, finding that plaintiff had a special valuable interest in the property accompanied with the right of possession. See also, Matthew v.

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* Likewise in this case, Teledyne did not have a right to direct the Bank of America to pay its invoices. If Teledyne had brought an action in conversion against the Bank, surely it would have failed.

Matthew, 71 P.344 (Sup. Ct. Cal. 1903); Everfresh, Inc. v. Goodman, 281 P.2d 560 (Dist. Ct. App. 1955).

It would appear that in every cited California case involving a special interest, the courts have found conversion only where a property interest, as opposed to a promise pay, existed. Uniformly, that property interest was evidenced by a "lien" relationship, i.e., a conditional sales contract giving the right to possession or an execution pursuant to judgment. No reported California case has held that an obligation to pay an invoice pursuant to a vendor-vendee relationship created a "special interest" in the vendor. For this reason, it is clear that the District Court exceeded its authority and created new California law, a result best left to the California courts.

POINT III

THE INDIVIDUAL DEFENDANTS-APPELLANTS CANNOT BE HELD LIABLE FOR THE ACTS OF EON CORPORATION

The District Court, having erroneously found that Eon undertook to act as a fiduciary on Teledyne's behalf and that Teledyne had a special interest in the bank account, concluded, without detailed analysis,

that the individual defendants-appellants were liable in damages for both breach of trust and conversion. It is respectfully submitted that the individual defendants-appellants may not be held liable in conversion because the strict liability rule of conversion is inapplicable within the corporate context and that the proof established that defendants-appellants were ignorant of the wrongfulness of disbursing the progress payments received from the government to anyone other than Teledyne.

In Poggi v. Scott, 167 Cal. 372, 139 P.815 (1914), relied upon by the District Court, which established the rule of strict liability for conversion, the convertors were not corporate directors or officers. It is respectfully submitted that the District Court wrongfully interpreted California law by holding that the rationale of Poggi should be applied in a corporate context.

Several California cases have dealt with alleged conversion by corporate officials. These cases make it clear that a director or officer of a corporation cannot be held liable for any innocent conversion done within his corporate capacity. In

each of the cases, the court held either that there was a requirement of knowledge or constructive knowledge, or the facts demonstrated that the directors or officers in fact had knowledge or constructive knowledge.

In Vujacich v. Southern Commercial Co., 21 Cal. App. 439, 132 P. 80 (Dist. Ct. App. 1913), two directors who had not personally participated in the misappropriation of funds appealed the lower court's finding of liability in conversion. The judgment was affirmed. The appellate court held that one of the appellants-directors had actual knowledge of the misappropriation. The other one, the court held, had constructive knowledge:

> It is true that no directors' meetings were shown ever to have been held and no evidence was introduced showing that actual knowledge was brought home to director R. E. Hansard of the condition of the affairs of the company, or its conduct with respect to the money of plaintiff. . . . On the other hand, this appellant did not testify or offer any proof showing that she had no such knowledge or that she

> could not have obtained it by the exercise of ordinary diligence as a director of the company. Where the business of receiving deposits by a corporation is so general as it was with the corporation defendant herein, it must be presumed that the directors had full knowledge of the manner in which such moneys were kept and used, and unless a showing is made of some excuse, such as a protest offered by the director not consenting to the misappropriation and of steps taken by such director to prevent loss from accruing to the depositors, such director becomes personally liable to the persons damaged. 21 Cal. App. at 442-3 (emphasis added).

In McClory v. Dodge, 117 Cal. App. 148, 4 P.2d 223 (Dist. Ct. App. 1931), the appellate court affirmed the lower court's finding that several directors were liable in conversion:

> Appellants, as directors of the [corporation], held monthly meetings and went over the affairs of the corporation minutely. . . .
>
> Appellants did not testify or offer any proof showing that they had no knowledge of how respondent's stock got into the possession of their company. Neither did they give any excuse why they could not have obtained such knowledge by the exercise of ordinary diligence.
>
> We think that, in view of all the facts and circumstances in this case, the directors were presumed to know the relation existing between the corporation and the respondent, and if by the exercise of reasonable diligence and care on their part they could and would have known that they did not own respondent's stock, they are personally liable to him for the value thereof.

> We think, also, that the evidence is sufficient to show that they had actual knowledge of the conditions under which the [corporation] held respondent's stock. 117 Cal. App. at 153 (emphasis added).

Thus, the court found that the directors-converters had both actual and constructive knowledge of the fact (i.e., plaintiff's ownership of the shares) which made their disposition of the shares tortious.

Mercer v. Dunscomb, 110 Cal. App. 28, 293 P. 836 (Dist. Ct. App. 1930), involved a corporation which bought and sold securities. In connection with the business the corporation operated a safe-deposit service for securities owned by its clients. Plaintiffs, who had some securities on deposit with the corporation, authorized the corporation to sell those securities and to use the proceeds to purchase some tax-exempt bonds. The corporation informed plaintiffs that the transaction had been carried out and gave plaintiffs an interim certificate for the bonds. Actually, two of the corporation's five directors had mingled the proceeds with the corporation's general funds and had spent them in the regular business of the company. A third director had consented to these actions. (All

three were also officers.) The liability of the participating directors, all of whom knew that their conduct was wrongful, was clear. The trial court found no liability as to the two non-participating directors, after excluding evidence offered by plaintiffs to prove that the actions taken with respect to plaintiffs' property were in accordance with the corporation's general practice. The appellate court held:

> [P]laintiffs. . .were entitled to show, if they could, that it was the general business of said corporation to receive deposits from its numerous clients and to issue interim certificates therefor; because. . .proof of such fact would have been legally sufficient to charge all of the directors as a matter of law with knowledge of the manner in which said deposits were being kept and disposed of, and consequently legally sufficient, in the absence of explanatory evidence showing individual effort on their part to safeguard and prevent the loss of such deposits, to establish against them prima facie liability for the misappropriation of such deposits to the use and benefit of the corporation by the officers thereof. No such explanatory evidence was introduced on behalf of [the two non-participating directors]. . . . The rulings excluding plaintiff's evidence were therefore prejudicial. 110 Cal. App. at 35 (emphasis added).

Thus, it would appear that, contrary to the District Court's ruling, no California case has held a corporate director or officer liable for conversion while acting in his corporate capacity, without sufficient evidence establishing that that director knew or should have known of the wrongfulness of his conduct. In the instant case, although arguably the act was done intentionally by the directors in that the monies in the special account at the Bank of America were utilized by the corporation to satisfy other corporate obligations, it is respectfully submitted that the court erred in that there was insufficient evidence to establish that the individual directors were aware that any restrictions had been placed upon the use of monies deposited in the Bank of America account.

The District Court erroneously held that appellants Anton and Srybnik were aware of the special account arrangement. Judge Knapp also found that it was "more probable than not that Podell and Waller knew of the restriction on the account." (A-48)

At the outset, it should be noted that appellee certainly has not satisfied its burden of proof by establishing a probability that Podell and Waller had certain knowledge. Both appellants were in New York, never participated in any discussions with Teledyne and were not involved in the day-to-day operations of Eon. The evidence is such that it is equally probable that neither knew anything about the account.

There was also insufficient evidence to establish that either Anton or Srybnik were aware of the existence of any restrictions placed upon the special account at the time of the alleged conversions. While, admittedly, both Anton and Srybnik were aware of the fact that monies were being paid to Teledyne out of the Bank of America account, they both testified that they were unaware of any special restrictions relating to payment and, particularly, were unaware of

Leonard's letter of May 25th to the bank. (A-624-25; 713, 846) They were, however, familiar with the terms of the purchase order which did not restrict the use of any funds.

Since Anton was the only officer or director of Eon present in California (1/2 day)* during the negotiations with Teledyne, any finding of knowledge by the District Court must, necessarily, have resulted through the inference that Leonard advised Anton and Syribnik of the restrictions on the bank account. Such a finding, however, directly conflicts with the conclusions of the District Court relating to appellee's fraud claim. In dismissing the fraud claim, the District Court held that it was mere conjecture that appellants knew or participated in the fraud. The court concluded that it would only have been an act of unwarranted omniscience on its part to infer that appellants were aware that misrepresentations may have been made by Leonard to help induce the contract. In so finding, the District

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* other than Leonard

Court recognized that Leonard was motivated by desires other than the best interest of Eon. In fact, it was clear that because Leonard was in a conflict of interest situation, the court could not assume that Leonard informed Anton (or anyone else) about any of the misrepresentations that were made with respect to the contract or various aspects of the negotiations, particularly an arrangement whereby a third party was paid a sales commission for his roll in arranging the negotiations between Teledyne and Eon.*

Despite the fact that the District Court recognized Leonard's antagnostic position on the fraud claims, it has, nevertheless, assumed the opposite position with respect to the restrictions placed upon the Bank of America account. There is no justification for the District Court to have concluded that Leonard ever advised Anton or Syribnik that there were restrictions on the bank account. There was simply no way for the court to determine what Leonard may or may not have told Eon's directors. More importantly, however, since

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* This finder's fee, paid in direct contravention to the terms of the purchase order, is significantly discussed in the companion appeal.

Leonard never believed that the account was restricted in the manner alleged by appellee, it is doubtful he would ever have told Eon's directors that the account was restricted.

POINT IV

TELEDYNE'S REFUSAL TO ACCEPT $216,000 IN PROGRESS PAYMENTS TENDERED BY EON, ESTABLISHES THE NON-EXISTENCE OF A TRUST FUND

While owing Teledyne a substantial amount for generator sets sold and delivered, Eon removed progress payments from its account in the Bank of America and utilized the money to pay other corporate obligors. At about that time, appellee wrote a letter to Eon claiming the money. Thereafter, at a meeting in New York, Eon, which was on the verge of bankruptcy, tendered to Teledyne $216,000, the full amount of the undisbursed progress payments. (A-882-83) Teledyne refused the tender, allegedly fearing that such payment would be deemed a preference in bankruptcy. Since the District Court's opinion did not refer to these uncontested facts, it can only be assumed that they were overlooked or deemed inconsequential. However, it is submitted that the refusal of the tender conclusively establishes that the parties never intended Teledyne to have any

special interest in the Bank of America account.

If Teledyne had intended and believed that it was the beneficiary of a trust or special interest, rather than merely a contract creditor as reflected by the documents, the $216,000 payment offered to Teledyne could not have been a preference, because Teledyne would have been entitled to the money as the beneficial owner. "The general accepted law in this country is that 'under the system now prevailing the cestui que trust is regarded as the real owner of the property, the trustee being merely the depositor of the legal title. This is not a property right, but a legal duty founded upon a personal confidence; his estate is not that which can be enjoyed, but a power that could be exercised.'" Title Ins. & Trust Co. v. Duffill, 191 Cal. 629, 647-8, 218 P.419 (1923).

The law is clear that the payment of trust funds to the beneficial owner thereof is not a preference in bankruptcy:

> If the bankrupt holds property in trust for another, the trustee in bankruptcy takes title to such property charged with the trust. So long as the property can be identified according

> to orthodox trust doctrines of tracing and identification, it will be treated in bankruptcy as property to which creditors of the bankrupt have no claim, and will be paid over as a whole before disbursements are made to lienholders or unsecured creditors.
> 3A COLLIER ON BANKRUPTCY §64.02[3], at 2069-70 (14th ed. 1973).

In In Re Tele-Tone Radio Corp., 133 F. Supp. 739 (D.N.J. 1955), the issue was whether money previously placed in a so-called "tax account" at a bank by a bankrupt corporation constituted a trust fund for the benefit of the federal government. While finding no trust, the court held that if there had been a tax trust, the money would have been paid over directly to the federal government rather than given to the trustee in bankruptcy. 133 F. Supp. at 741-2.

It is urged that Teledyne's refusal to accept the $216,000 indicates serious doubt in the minds of the Teledyne officials and their counsel as to the existence of a trust. Contrawise, the District Court, apparently not considering this evidence, based its decision in large part on what was going on in the minds of the Teledyne officials:

> There can be little doubt after considering the testimony adduced at trial that the evidence convincingly supports plaintiff's version of the intended purpose of the special account arrangement.

> To put it quite bluntly, no other explanation makes any sense whatsoever.
>
> First, Rouse and Coleman both were concerned over Eon's ability to meet its financial obligations under the proposed subcontract. . . .
>
> The documentary evidence further supports the view that the parties intended that Eon's use of the Army funds on deposit would be restricted first to the payment of Teledyne invoices only. (A-46-47)

The District Court never explained this apparent contradiction in its findings. It is submitted that the explanation is simply that there never was any intent to create any special rights for Teledyne. The theory of trust and special interest was apparently developed by counsel for Teledyne after the fact.

If Teledyne's refusal of the tender is not sufficient to disprove the existence of the trust or special interest altogether, it clearly is sufficient to reduce Teledyne's judgment by $216,000, the amount of the tender. Having once refused the money, appellee cannot now be heard to claim that appellants converted same.

POINT V

BY REASON OF THE EXCLUSIVE JURISDICTION OF THE BANKRUPTCY COURT AND TELEDYNE'S PARTICIPATION THEREIN, THE DISTRICT COURT LACKED JURISDICTION

On or about January 12, 1973, Eon filed a petition for an arrangement in the United States District Court, Eastern District of New York, pursuant to Chapter XI of the Bankruptcy Act (11 U.S.C. §701, et. seq.). Thereafter, a restraining order was issued by the Hon. Emanuel J. Price, Referee in Bankruptcy, upon Teledyne's attorneys. Teledyne filed its proof of claim, dated March 13, 1974, with the Bankruptcy Court, thereby voluntarily invoking the exclusive jurisdiction of the Bankruptcy Court. Teledyne actively participated in the bankruptcy proceedings as an unsecured general creditor by objecting to the confirmation of Eon's proposed plan of arrangement. Judge Price dismissed Teledyne's objection to confirmation "in all respects" by his decision dated November 18, 1974 and ordered thereon dated November 27, 1974. Thereafter, Teledyne elected to participate in Eon's plan of arrangement by accepting convertible preferred stock under the plan of arrangement.

The national polic as enunciated by the Congress, conferred exclusive summary jurisdiction to the Bankruptcy Court to determine controversies with respect to property owned by Eon to which any claim may have been made by Teledyne. 11 U.S.C. §714 It can hardly be disputed by Teledyne that the monies deposited into American Marc's bank account were property in the form of a fund owned and held in the exclusive legal possession of Eon, and to which Teledyne could have claimed title. The very essence of the proceedings before this court deals with Teledyne's alleged claim of a property interest in Eon's money. Under all of the circumstances, the Bankruptcy Court and not this court, had exclusive jurisdiction of the affairs of Eon and its property. Thompson v. Magnolia Petroleum Co., 309 U.S. 478.

The District Court should not have exercised jurisdiction in this case. By so doing, the court acquiesced in Teledyne's subversion of the bankruptcy law and the national policy sought to be implemented thereby. It permitted Teledyne to unilaterally strip the Bankruptcy Court of its power and jurisdiction,

by personally attacking the directors of the corporation and thereby obtaining preferential treatment.

In the bankruptcy proceeding, Teledyne failed to obtain an adjudication that the monies in Eon's Bank account belonged to it and further failed to prevent a discharge of Eon's debt to it. Such action on behalf of Teledyne is a clear indication of the absence of fraud or conversion in connection with the transaction between American Marc and Teledyne. Judge Price's decision and order dismissing Teledyne's objections "in all respects" must be given res judicata or collateral estoppel effect as to all claims which Teledyne asserted and which could have been asserted in the bankruptcy proceedings. Cromwell v. Sac County, 94 U.S. 351 (1877); Walter E. Heller & Co. v. Cox, 343 F. Supp. 519, (S.D.N.Y. 1972) aff'd without opinion, 46 F.2d 1398 (2d Cir. 1973).

Analysis of the bankruptcy law makes it clear that fraud, conversion, misappropriation or defalcation while acting in a fiduciary capacity, by a debtor in bankruptcy, denies the debtor a discharge of the debt arising out of or connected with the fraud, conversion or misappropriation. 11 U.S.C. §35(a)(c); Rules of Bankr. Proc., Rule 409; Rule 11-38.

At no time did Teledyne seek to enforce its claims of alleged fraud, conversion or misappropriation of funds in the Bankruptcy Court. Bankruptcy Judge Price's dismissal of Teledyne's objections as to the issues it raised and could have raised is binding upon this court on the issues of fraud and conversion. To ignore Bankruptcy Judge Price's determination would, in effect, construe the acts of the Bankruptcy Judge as ratifying and condoning fraud and conversion by Eon. Teledyne was an active participant in the bankruptcy proceedings and not having prevailed in its objections to the confirmation to Eon's plan of arrangement and the discharge of Eon's debt to Teledyne, it must be barred from asserting a fraud or conversion herein.

The summary jurisdiction and equity powers of the bankruptcy court were sufficient, had Teledyne acted, to enable it to pursue its remedies and reclaim and trace alleged trust funds. Johnson v. Morris, 175 F.2d 65 (10th Cir. 1949). Since Teledyne refused and failed to act in the bankruptcy proceeding, it has, through its own unilateral action, destroyed the individual appellants' right to subrogation and indemni-

fication which would have existed had the assets been traced and recovered in the bankruptcy proceeding. Not having acted in the bankruptcy proceeding, Teledyne should not now be heard to recover from the individual appellants when they no longer have an opportunity to recover the amounts which were transferred and utilized by the corporation to pay other corporate obligations.

The District Court below dismissed the challenge to its jurisdiction on grounds of the exclusive jurisdiction of the Bankruptcy Court holding that the subject matter of the instant action did not involve property which was in the actual possession of Eon. It is respectfully submitted that the court erred in that it artificially created a distinction between the cause of action for conversion against the individual appellants and any claim which might have been raised in the bankruptcy proceeding against Eon.

The fact of the matter is that there can be no finding of a conversion against the individual appellants unless, at least sub silentio, there is a finding that Eon converted Teledyne's "special interest" in the bank account. The individual appellants were, at all times, acting within their corporate capacities and

without personal gain. Appellants' actions were the actions of the corporation and a finding of conversion against the directors is tantamount to a finding of conversion against the corporation. Thus, there exists a clear relationship between the claims which could have been raised against Eon in the bankruptcy proceeding and the conversion claims raised against appellants. When Teledyne failed to raise a claim of trust, fraud or conversion in objection to the discharge of Eon in the bankruptcy proceeding it, at least impliedly, consented to the discharge and thereby negated any inference of wrongdoing, conversion, fraud or misappropriation by the corporation. It is urged that the same is true with respect to appellants. As the situation now exists, although the corporation did not convert, its officers and directors did. The anomaly of this situation highlights the error of the District Court.

CONCLUSION

THE JUDGMENT OF THE DISTRICT COURT SHOULD BE REVERSED AND JUDGMENT ENTERED DISMISSING THE COMPLAINT IN ALL RESPECTS.

Respectfully submitted,

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Dated: New York, New York
October 25, 1976

Robert R. MacDonnell:

Of Counsel

Due and timely service of TWO copies
of the within BRIEF is hereby
admitted this 26TH day of OCTOBER 1976.

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Attorneys for APPELLEE